



## **FIRST STEPS TO REFORM TAX CREDITS**

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Tax credits are helping to reduce child poverty. Millions of families with children are benefiting financially, and more parents are finding that tax credits help to make work pay. But they are also complex to understand, and their administration so far has been poor. Child Poverty Action Group believes that the Government must address the administrative problems as a matter of urgency, so that families no longer have to battle against poor administration and incomprehensible decisions. Longer term, more fundamental reforms may be needed to ensure that the tax credit scheme works more effectively in the interests of claimants. In this paper, we propose six immediate steps to reform:

- An amnesty of overpayments that arose in 2003/4 and 2004/5.
- Introduce a right of appeal against overpayment decisions
- No automatic recovery
- Fair recovery of overpayments
- Improve communication and advice to claimants
- Encourage take up of tax credits

Child tax credit (CTC) and working tax credit (WTC) were introduced in 2003 and large numbers of people have benefited from the increased financial support they have given. There are, however, serious problems with the design and operation of tax credits which are in danger of undermining the government's twin objectives of tackling child poverty and encouraging people back to work by making work pay. Tax credits at present do not provide a secure form of income because of the fluctuating nature of the award which is in part the result of an annualised system of income assessment. An ongoing record of mistakes by Her Majesty's Revenue and Customs (HMRC) and the manner in which overpayments have been recovered have together created a major credibility problem for tax credits. Claimants have experienced frustration, delays, extreme anxiety and poverty as a result of the recovery procedures and the inability to obtain adequate information and help about their claims from the HMRC. Unless both the service and the system that has created the overpayments crisis can be reformed the positive message underlying tax credits will be destroyed thus undermining key parts of the government's social programme. The particular problems of tax credits have recently been highlighted by reports by Citizens Advice, the Parliamentary Ombudsman, the House of Commons Public Accounts Select Committee and the National Audit Office. CPAG is making the following proposals now which will be an important introduction to a programme of reform, but longer term more fundamental design issues still need to be addressed.

### **An amnesty on overpayment recovery.**

CPAG believes the government should declare an amnesty on all overpayments up to April 2005 where fraud has not been proven. Administrative delays when the system was introduced, income and changes of personal circumstances incorrectly reported or recorded, computer error, mistakes by staff and mistakes by claimants have all contributed to the current overpayments crisis. Because of these problems and the existing system of overpayment recovery many low income families are repaying their tax credit overpayments at rates causing great hardship; they are also carrying forward large amounts of tax credits debt to repay over future years. The

HMRC therefore need to start with a clean slate from the start of this tax year (2005/06) in order to:

- overcome the hardship caused to families by the recovery of tax credits incurred in 2003/4 and 2004/5;
- overcome the problem that has meant that claimants disputing overpayments are not dealt with equitably;
- reduce the burden on HMRC of assessing the backlog of disputed overpayments and allow it to prioritise ongoing work to ensure that the same level of overpayments does not recur;
- rebuild public confidence in tax credits.

CPAG believes HMRC needs to review its systems and delivery to reduce the incidence of overpayments in the future. We welcome the Paymaster General's statement (26 May 2005) that HMRC may try to do this. However, without an amnesty there is no chance of achieving equity for those who have already suffered as a result of overpayments. CPAG is also concerned about the test as set out in Code of Practice (COP 26) for deciding whether an overpayment should be recovered. It appears that in almost all cases - even if HMRC has made serious mistakes - the claimant will still be required to repay. This has been changed temporarily by the operation of a "secret" (streamlined) formula, introduced by HMRC in April 2005 to facilitate the clearance of the backlog of disputed overpayments. Where cases are dealt with under this temporary formula it seems that most overpayments for 2003/4 (and 2004/5 in year overpayments) will have been waived. However the result is that claimants who disputed claims will have been dealt with differently according to the date at which their case was processed. Those who did not dispute the overpayments at all will have had no relief.

Child tax credit and working tax credit are crucial to the delivery of the key policy target of halving child poverty by 2010/11 and making work pay. But the continued automatic recovery of overpayments is reducing many families to incomes below subsistence level. It is essential that the system designed to support people on low incomes is reformed so that public confidence in tax credits can be restored. An amnesty would demonstrate publicly that the HMRC's first priority is to get a decent and stable income through to those families who need it.

### **Introduce a right of appeal against an overpayment decision.**

The existing policy on recovering overpayments is set out in the HMRC's Code of Practice on Overpayments (COP26) which states the HMRC will not recover if:

- a mistake was made by the HMRC, *and*
- it was reasonable for the claimant to believe the award was right.

In most cases the second part of the test is not considered. It is only applied if the claimant disputes the recovery and the HMRC will have *already* begun to recover the overpayment.

CPAG believes there should be a statutory test to decide recovery of overpayments and for a right of appeal against a decision that there has been an overpayment. Recovery should be suspended pending the outcome of the appeal. Claimants should be separately notified of the overpayment, the amount, how it arose and when. Statutory oversight of the test of recovery of overpayments would improve decision making and encourage an accurate interpretation and implementation of the law.

In the interim CPAG believes that the application of the current official error test in COP 26 is inappropriate and is based on an unreasonable assumption about what a claimant should know about their award. Moreover, the lack of clear information on current award notices means it has been virtually impossible for claimants to form a view about whether they have been receiving the right amount of tax credit in 2003 and 2004. CPAG believes that until the award notices are improved the HMRC are interpreting the second part of the test to decide recovery unduly harshly. We recommend that the second arm of the test be suspended until clearer information is available to claimants on the award notices.

### **No automatic recovery**

Recovery of overpayments starts automatically as soon as the overpayment is identified. Even if the claimant disputes the overpayment arguing there is official error, (that the HMRC has made a mistake) the HMRC will continue to recover until a decision is made on the claimant's disputed overpayment. Before recovery starts there is also no time for the HMRC to consider making a discretionary additional payment of tax credits to provide some partial protection to the claimant's income in cases of hardship.

By the time a decision whether or not to recover is made a claimant will have had a considerable amount of the overpayment recovered. CPAG believes this automatic recovery of overpayments is unlawful - the primary legislation gives HMRC the power to exercise its discretion on recovery of overpayments, yet the computer is programmed to recover automatically.

CPAG believes that at the very least there should be a period before recovery starts in which the claimant has the opportunity to contest the recovery whether on grounds of official error or hardship. Once HMRC receives notification from the claimant that they wish to dispute the overpayment, recovery should continue to be suspended until the claimant's case has been investigated.

### **Fair recovery of overpayments**

Currently overpayments identified in year are recovered by adjusting the award for the remainder of the year so that the overpayment is recovered by the end of the year. This takes no account of the ability to pay and can result in awards being reduced or wiped out altogether causing extreme hardship to many claimants. Although claimants can apply for discretionary additional payments to compensate in part for this loss these do not adequately protect the claimant's income. They are not paid automatically and the Code of Practice on overpayments specifically excludes some claimants.

End of year overpayments are recovered by deductions that are a percentage of the award – at 10%, 25% and 100%. The 100% deduction is applied to those in receipt

of child tax credit, family element only; the 10% to those in receipt of maximum rate tax credit. The 25% applies in any other case (this includes families on low pay who receive maximum CTC but reduced rate of WTC because their pay is above £5,220 in 2005/06). The jump in rates, from 10% to 25%, can result in large differences in repayment rates which are not proportionate to the increase in household income – and this causes hardship. Moreover using percentages of awards, rather than a flat rate figure, to calculate deduction rates produces higher deductions for those entitled to higher maximum awards, for example those with more children and those with disabilities.

The existing system of support also means that for the first time some claimants are having deductions made to repay overpayments from an allowance specifically paid for children – their child tax credit. This is forcing people to live below the poverty line and having disastrous consequences for those dependent on safety net benefits.

CPAG believes that any recovery policy should have a primary aim to mitigate poverty and to protect income for children. We set out our approach below:

- CPAG believes that deductions from WTC and CTC to recover overpayments must be made in accordance with the general principle of the ability to pay. Key to this are that HMRC:
  - agree one approach to recovery, irrespective of whether the overpayment is discovered in year or at the end of the year;
  - reduce the current jump in deduction rates between 10 % and 25 %, perhaps by adding a 15 % rate (which could then be applied to families on maximum CTC but whose WTC is reduced because their earnings are above £5,220 per year);
  - investigate applying percentage deductions to a fixed part of the award, not a percentage of the whole (which currently disadvantages larger families and people with disabilities).
- There should be no deductions from child tax credit. In particular overpaid WTC should not be recovered from CTC, particularly if the CTC is paid at the maximum rate.
- Where claimants are no longer in receipt of tax credits and the overpayment cannot be deducted from a future award a similar rate of recovery should be payable direct in instalments. This will also apply where the overpayment arose during a past claim (for example as a couple) and the current award is made to a lone parent.
- Whatever the cause of the overpayment and however the overpayment is being repaid claimants should have access to discretionary additional payments if recovery at the above rates would cause hardship. No claimant should automatically be excluded from these as is currently the case.

## **Improve communication and advice**

The standard of advice and information available via the Helpline should be improved. Helpline staff appear to be inadequately briefed on both the law and the progress of particular cases. Staff must be able to track the history of cases and to deal with complex queries from welfare rights advisers which require detailed

examination of cases. Computer processes need upgrading; there are too many computer errors and design limitations, for example, reporting a change of circumstance does not guarantee it will be entered on the computer or produce the right award.

HMRC must recognise that the needs of tax credit claimants are varied and provide information accordingly, for example, there is too much reliance on online information. Many claimants do not have computers or do not have easy access to them.

The HMRC provides detailed notes to go with forms and notices which are often long and complex. However the information provided does not explain award notices particularly where these are complicated by overpayments. To reach all of the tax credit population the HMRC need to recognise the need for an outreach approach and the need to provide a face to face information service. Some claimants who receive tax credits have limited literacy and numeracy skills; others will need occasional access to expert information and then deal with the tax credit forms independently. There is no one right way to reach those who claim tax credits.

As a priority the HMRC should establish a face to face information service to help claimants with:

- Completing claim and renewal forms. The claim form, for example, currently requires claimants to deal with explanatory notes of up to 56 pages.
- Understanding award notices. For at least one more year claimants will have to rely on inadequate, often incomprehensible award notices. Improved award notices are expected from 2006, but they are likely to remain particularly complicated for those whose circumstances and income have been subject to a number of changes. It is therefore likely that many claimants will still need help with understanding award notices in future years. It also seems unlikely that the additional payments will be incorporated into the award notice by 2006 and therefore claimants in receipt of these will need additional help with understanding how the award notice and additional payments interact.
- Understanding the implications of reporting changes of circumstances and income and the amount of tax credit that will be paid as a result.

Staff in direct contact with the public will be in a good position to deal with the issue of interim (emergency) payments and additional payments. These staff should have the knowledge to explain how additional payments can protect the claimant's income.

Reliance on contact via the Helpline is insufficient for more complex cases and the most vulnerable claimants. Many claimants on a low income are used to budgeting on a weekly basis. The tax credits system with awards based on annual income and with completely different rules and principles creates difficulties particularly for those on low and unpredictable incomes and for those who experience frequent changes of circumstances. Claimants need to be able to talk through a claim with a member of staff at HMRC with both staff member and claimant able to study the same documents.

More complicated cases need a case work approach in order to resolve longstanding problems. Although there is one team of staff now established to deal with cases that might otherwise lead to a complaint being made this is not adequate to meet the needs of applicants throughout the country who have accumulated tax credit

problems since the scheme began. There should be scope to refer problems to specialist units with sufficient staff available to take ownership of specific cases. This would also facilitate more effective contact between advisers in the independent sector and HMRC staff, which would benefit claimants. At present advisers complain that it is impossible to resolve issues, clarify information relating to a client, and assess the progress of a case.

CPAG therefore recommends that some HMRC staff be based in local Jobcentre Plus offices as these may be more accessible to more people and would aid co-operation between HMRC and the DWP in the delivery of financial support. The voluntary sector has a role to provide independent advice and advocacy, but they are not there to deliver tax credits.

### **Encourage take up of tax credits.**

Maximum take up is an essential precondition for making tax credits effective and providing a means to make work pay and reduce child poverty. In fact in 2003/4 one in five entitled to tax credits did not claim. Moreover the official statistics review showed that 13% of awards had an underpayment. Although this would have been subsequently repaid to the claimant it means that the right money was not paid to the claimant at the time the money was needed. Take up and the decision to go into work may also be affected by the widespread publicity around debts created by tax credit overpayments.

The tax credits system must be one that is more transparent, in which the public have confidence and do not fear being plunged into debt through no fault of their own. That means providing the support and assistance to remove the barriers to claiming and to assist general understanding of how tax credits work.

## **THE FUTURE**

The proposals outlined above concentrate largely on the delivery of tax credits but there are more fundamental design problems which CPAG believes require further consideration. The existing system which depends on an annual income calculation as the basis for the award has the following effect:

- Increases in income (most likely to occur for example where a partner returns to work) create automatic overpayments. In some cases this will mean that the tax credit overpaid for the first part of the year will then wipe out the award for the remaining months of the year.
- Awards, initially based on previous year's income, may not reflect current circumstances. Instead claimants can ask for the award to be based on an estimate of current year's income. However claimants may not know they can request this, it can be a protracted process and can also produce problems if estimates of the current year income are wrong.

The fact that either the current year, with or without an income disregard, or the previous year can be the basis of the finalised awards adds to the complexity.

CPAG believes that tax credits must provide a secure and understandable system of financial support for recipients. In the longer term, more radical reform may be

needed to ensure a reformed tax credit system that is both easier to understand and can more effectively deliver the financial support that families deserve and need.

### **About CPAG**

CPAG is the leading charity campaigning for the abolition of poverty among children and young people in the UK and for the improvement of the lives of low income families. CPAG aims to: raise awareness of the extent, nature and impact of poverty; bring about positive income policy changes for families with children in poverty; and enable those eligible for benefits and tax credits to have access to their full entitlement.

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